Internal Revenue Service
memorandum

CC:FS:P&SI
JRosenberg

date: DEC 26 1991

to: District Counsel, Newark
Attn: Robert A. Baxer

from: Assistant Chief Counsel (Field Service)

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subject: [redacted] - Conversion of Partnership Items
TL-N-311-92
CC:FS:PS&I Rosenberg Wilson
I.R.C. §§ 6231(c), 6229(f), Temp. Treas. Reg. § 301.6231(c)-7T

This memorandum is in response to your request for field service advise dated September 27, 1991.

ISSUES

1. Does the bankruptcy of a pass-thru partner convert partnership items from the source partnership into nonpartnership items for the indirect partner?

2. Is an indirect partner's period of limitations for tax attributable to partnership items of a source partnership affected by the conversion of the pass-thru partner's partnership items to nonpartnership items?

CONCLUSIONS

1. No. A TEFRA proceeding with respect to a source partnership is binding on "partners" of the source partnership, including any indirect partners holding their interest through a pass-thru partner. See I.R.C. §§ 6221, 6226(c), and 6231(a)(2)(B). Only an event personal to an indirect partner would convert his source partnership items to nonpartnership under section 6231(b). Thus, the bankruptcy of the pass-thru partners will have no effect on the indirect partners.

2. The period of limitations under section 6229(a) will continue to control with respect to an indirect partner's tax attributable to partnership items of a source partnership even though the pass-thru partner's partnership items have converted to nonpartnership items.

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FACTS

[redacted] is a TEFRA partnership which [redacted] in [redacted]. [redacted] has two general partners, both of which are subchapter S corporations. One flow-thru entity, [redacted], owns [redacted] percent of [redacted]. The other flow-thru entity, [redacted], owns a [redacted] percent interest in [redacted]. The sole shareholder of each of the flow-thru entities is [redacted].

[redacted] and its two flow-thru partners have all filed bankruptcy petitions under Chapter 11 of the bankruptcy laws. All of the bankruptcy petitions were filed on [redacted] and the plans were subsequently confirmed on [redacted]. [redacted] has not filed a petition in bankruptcy.

DISCUSSION

Issue 1

As part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, 648-671, Congress provided for the determination of the tax treatment of any partnership items through unified audit and litigation procedures at the partnership level. See I.R.C. § 6221. The determinations made at the partnership level are binding with respect to "partnership items" of "partners." Id.; see also I.R.C. § 6226(c). The definition of a partner includes, "any other person whose income tax liability under Subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." I.R.C. § 6231(a)(2)(B).

An indirect partner1/ holding an interest in a pass-thru partner2/ has its tax liability under Subtitle A determined in whole or in part by taking into account indirectly partnership items of the source partnership. Thus, indirect partners are

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1/ The term "indirect partner" is defined in section 6231(a)(10) as a person holding an interest in a partnership through one or more pass-thru partners.

2/ The term "pass-thru partner" is defined in section 6231(a)(9) as a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which unified proceedings are conducted. The pass-thru partner is commonly reffered to as a tier and the partnership in which it holds an interest is called the source partnership.

"partners" of the source partnership whose "partnership items" will be determined in the TEFRA proceeding.3/ See I.R.C. § 6226(c) ("partners" treated as parties to partnership litigation). Because the indirect partner is a "partner" in the source partnership, only the occurrence of an event personal to the indirect partner under section 6231(b) should operate to convert the indirect partner's partnership items from the source partnership to nonpartnership items. Moreover, since a partnership (or S corporation) is separate and distinct from its partners (or shareholders), the indirect partner is not affected by the bankruptcy of a tier. See 1983 Western Reserve Oil and Gas Co., Ltd. v. Commissioner, 95 T.C. 51 (1990); and Chef's Choice Produce Ltd. v. Commissioner, 95 T.C. 388 (1990). Hence, notwithstanding that a tier is a partner and the bankruptcy of a partner will normally convert the debtor's partnership items into nonpartnership items pursuant to Temp. Treas. Reg. § 301.6231(c)-7T, the bankruptcy of the tier will not convert the partnership items of the indirect partners into nonpartnership items.

The policy of direct application of a TEFRA proceeding to indirect partners is further reflected in section 6223(c). Section 6223(c)(3) provides a special rule for notice to indirect partners of partnership proceedings under certain circumstances indicating that TEFRA rules apply directly to indirect partners independently of their application to pass thru partners. In this case, [redacted], the indirect partner, satisfies the requirements for direct notice since he is a "person ha[ving] a profits interst in the [source] partnership by reason of ownership of an interest through one or more pass thru-partners" in that he holds an interest in [redacted] (the source partnership) through both [redacted] and [redacted] (the pass-thru partners). I.R.C. § 6223(c)(3)(A). In addition, we understand that [redacted] has been identified as provided in section 6223(c)(3)(B). Since [redacted], the only indirect partner of [redacted], has been identified to the Service, the Service should issue notice of partnership proceedings of [redacted] directly to [redacted].

In any event, the definition of "partner" indicates that [redacted] will be directly bound by any TEFRA proceeding at the source level ([redacted]). I.R.C. § 6231(a)(2)(B). Since the relevant "partnership items" of [redacted] are the partnership items of [redacted], and partnership items are converted to nonpartnership items only by the occurrence of an event with respect to the "partner" in issue, the filing for bankruptcy by

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3/ See also, W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, paragraph 3.01[2] (2d ed. 1977) (The definition of a "partner" as a member of a partnership under under section 761(b) includes indirect partners)(citing cases).

the pass-thru partners ([redacted] and [redacted]) has no effect upon the source partnership items with respect to [redacted].

Issue 2

The period of limitations for assessing tax attributable to partnership items is generally controlled at the partnership level. Pursuant to I.R.C. § 6229(a) the period for assessing any tax imposed by subtitle A attributable to partnership or affected items shall not expire before three years after the later of the date the partnership return was filed or the last day for filing such a return.

Section 6229(f) sets out the period of limitations on assessment which controls for partnership items which have converted to nonpartnership items. Under section 6229(f), the Service has one year from the date the partnership items convert to nonpartnership items to make an assessment or to issue a notice of deficiency pursuant to section 6230(a)(2)(A)(ii).

We previously concluded that the bankruptcy petitions filed by [redacted] and [redacted] will not cause the source partnership items from [redacted] to convert to nonpartnership items as to the indirect partner [redacted]. Consequently, the period of limitations under section 6229(a) will continue to control with respect to an adjustment of [redacted]'s flow-thru partnership items from [redacted] and [redacted] that are attributable to [redacted].

With regard to [redacted] and [redacted], the filing of petitions in bankruptcy by each of those entities has caused their partnership items attributable to [redacted] to convert to nonpartnership items pursuant to Temp. Treas. Reg. § 301.6231(c)-7T. As a consequence, the period of limitations for assessment of these items would generally be one year from the date of the filing of the petitions in bankruptcy pursuant to section 6229(f). However, since both [redacted] and [redacted] are S corporations, they are generally exempt from federal income taxation pursuant to section 1366.4/ Therefore, notices of deficiecy asserting adjustments

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4/ An S corporation may pay special taxes on its income in certain situations: (1) if the S corporation has subchapter C earnings and profits and gross receipts of more than 25% of which are passive investment income, a tax is imposed on excess net passive income pursuant to section 1375; (2) a built-in gains tax (applicable generally for C corporations converting to S corporation status after 1986) is imposed upon the distribution of an asset within the first 10 years after electing S status, on the gain attributable to the appreciation in the value of the asset as of the date of conversion pursuant to section 1375; and (3) if investment credit property is disposed of prematurely and

from [redacted] should not be issued to either [redacted] and [redacted].

We note that the three year period of limitations under section 6229(a) can be extended by the TMP with respect to all partners (including indirect partners) in an agreement pursuant to section 6229(b)(1)(B). Thus, any consents to extend to the period of limitations to assess the partnership items from [redacted] should be obtained from the partnership's TMP. Any valid consent executed by the partnership's TMP will be effective to extend the period of limitations with respect to [redacted]. We note that as discussed more fully below, due to the bankruptcies of [redacted] and [redacted], each of these entities are not eligible to be TMP of [redacted].

Alternatively, since [redacted] is the only partner (whether direct or indirect) with an interest in the outcome of a TEFRA proceeding concerning [redacted], we suggest that you obtain a consent (Form 872-P) from him pursuant to section 6229(b)(1)(A). This consent would be effective to extend the period of limitations under section 6229(a) with respect to [redacted]'s partnership items from [redacted].

Miscellaneous Issues

In addition to the issues addressed above, your request for field service advice also requested our views to the specific questions set forth in the memorandum to your office dated August 27, 1991 from Examination relating to this case. Each of those questions will be discussed in more detail below.

Q.1) Which items and what years have converted from partnership to nonpartnership items?

A.1) Pursuant to Temp. Treas. Reg. § 301.6231(c)-7T the filing of a bankruptcy petition by a partner will convert that partner's partnership items to nonpartnership items. In this case, the partnership items of [redacted] and [redacted] that are attributable to [redacted] will convert to nonpartnership items. However, based on our conclusion as to Issue 1 discussed above, the bankruptcy petitions filed by [redacted] and [redacted] will not cause [redacted]'s flow thru partnership items that are attributable to [redacted] to convert to nonpartnership items.

With regard to what years have converted to nonpartnership items for [redacted] and [redacted], basically there are two requirements that must be met before partnership items will convert: (1) the government must be able to file a claim for tax attributable to

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credit was allowed prior to the S corporation's election, investment tax credit recapture may apply under section 47.

those items; and (2) the partnership's taxable year must have ended on or before the latest year of the partner for which a claim could be filed.5/

Items for prepetition years for which the Service can file a proof of claim will always convert. Whether or not items for postpetition years convert is more complicated. In order to determine which partnership items convert, it is necessary to ascertain the latest taxable year of the partner for which the government could file a claim in bankruptcy for tax attributable to the partnership interest. In a chapter 11 case, this date will be the latest year the partnership interest is in the possession of the bankruptcy estate.

Under Temp. Treas. Reg. § 301.6231(c)-7T if the partnership's taxable year ends on or before the latest year of the partner for which a claim could be filed, then the partnership items of the partner will convert to nonpartnership items as of the date the bankruptcy petition is filed. If the partnership's year does not end on or before such date, then regardless of whether a claim could be filed, the partnership items for that year will not convert.

In this case, the chapter 11 bankruptcy petitions were filed on [redacted] by both [redacted] and [redacted], and the plans were confirmed on [redacted]. After confirmation the bankruptcy estates no longer exist, and claims for administrative expenses can no longer be filed. However, by [redacted], assuming that [redacted] is a calendar year taxpayer, its [redacted] taxable year had not ended, so [redacted]'s and [redacted]'s partnership items for [redacted] do not convert. Accordingly, [redacted] is not the latest year for which claims could be filed. However, the bankruptcy estates clearly were in existence for [redacted], so any tax liabilities were those of the estates, and a request for payment of tax attributable to partnership items could be filed. In addition, the partnership's taxable year has ended for [redacted]. Therefore, [redacted] is the latest year for which claims could be filed by the government in each of the corporate partners' bankruptcy proceedings. Accordingly, all partnership items for [redacted] and earlier years convert.

Q.2) What is the date of conversion?

A.2) Pursuant to Temp. Treas Reg. § 301.6231(c)-7T, it is the filing of the bankruptcy petition that is the converting event which starts the running of the one year period of

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5/ The term "claim" is given a broad reading. Claim for purposes of the temporary regulation means both a proof of claim pursuant to Bankruptcy Code section 501 and a request for administrative expenses pursuant to Bankruptcy Code section 503.

limitations on assessment under section 6229(f). Under the present scenario, the conversion date would be [redacted], the date that [redacted] and [redacted] filed their petitions in bankruptcy.

Q.3) What is the statute date for assessment of tax attributable to converted items?

A.3) See discussion in Issue 2.

Q.4) If and when the pass-thru partners emerge from bankruptcy, do these nonpartnership items reconvert to partnership items?

A.4) There is no statutory or regulatory authority that provides that these items reconvert back to partnership items once the partner's debts have been discharged in bankruptcy.

Q.5) Can a regular extension be secured on the corporate partners (872 on corporate partners) in [redacted] to extend the statute for assessment on the converted partnership items?

A.5) See discusion in Issue 2.

Q.6) Who is the TMP when both corporate partners ([redacted] and [redacted]) are named in bankruptcy petitions? Can [redacted] which emerges as a new partner after exiting bankruptcy be the TMP?

A.6) Pursuant to section 6231(a)(7)(A), the TMP of any partnership is the partner designated by the partnership to be the TMP. Temp. Treas. Reg. § 301.6231(a)(7)-1T provides the procedures that the partnership must follow to designate a TMP. If there is no partner who has been so designated, the TMP is the partner having the largest profits interest in the partnership at the close of the taxable year involved. I.R.C. § 6231(a)(7)(B). If more than one partner has the largest profits interest, then the TMP is the partner whose name appears first alphabetically. However, if there is no partner designated by the partnership to be the TMP and the Secretary determines that it is impracticable to apply the largest profits interest rule, the partner selected by the Secretary shall be treated as the TMP. I.R.C. § 6231(a)(7). Cf. Rev. Proc. 88-16, 1988-1 C.B. 691, § 3.03.

In this case, prior to the bankruptcy filings, in the absence of any designation of TMP by [redacted], the TMP would have been [redacted], which holds a [redacted]% interest in [redacted], by virtue of having the largest profits interest in the partnership. However, Temp. Treas. Reg. § 301.6231(a)(7)-1T(m)(3) provides that a partner's status as TMP is terminated upon the filing of a petition naming that partner as a debtor in a bankruptcy

proceeding. Thus, [redacted]'s status as TMP would have terminated upon the filing of the bankruptcy petition in accordance with the temporary regulations.

Since both [redacted] and [redacted] have been named as debtors in the bankruptcy petition, it would appear that each would be ineligible to be designated as TMP of [redacted]. However, since the bankruptcy plan has already been confirmed by the court, and no TEFRA proceeding has commenced with respect to [redacted], an issue arises as to whether either of these entities can be designated by the partnership or selected by the Service as TMP of [redacted], notwithstanding the fact that its partnership items for the years prior to [redacted] have converted to nonpartnership items.

It is unclear whether a TMP or a general partner who has been granted a discharge of debts prior to the beginning of the partnership proceeding can be a TMP. Although the Tax Court noted in Computer Programs Lambda, Ltd. v. Commissioner, 89 T.C. 198 (1987), that a TMP does not have to have a personal stake in the outcome of the proceeding and that a personal interest is not relevant, the court found that the status of the TMP who had filed a bankruptcy petition had still terminated. One of the reasons discussed for the termination of the status of the TMP was the effect of the automatic stay under 11 U.S.C. § 362(a)(8). In cases where the TMP has been granted a discharge of debts prior to the beginning of the partnership proceeding there is no automatic stay to affect the partnership proceeding. The TMP will no longer have an interest in the outcome of the proceeding since the TMP's partnership items will have converted upon the filing of the bankruptcy petition. However, the fact that he filed a bankruptcy petition may not terminate his status as a partner (which depends upon state law), although it will terminate his status as a party to the TEFRA proceeding. See I.R.C. §§ 6226(c) and 6226(d). The TMP may still have the ability to function as TMP. Computer Programs, supra at 205. Nevertheless, because of the unsettled nature surrounding this issue, we would not recommend selecting [redacted] or [redacted] as TMP of [redacted].

Exhibit #2 attached to Exam's memorandum indicates that [redacted] ([redacted]) will emerge after the bankruptcy as a new general partner of [redacted]. [redacted] will hold a [redacted]% interest in the partnership, which is the same percentage interest that [redacted] will hold. [redacted] would be eligible to be designated TMP by the partnership for any of the years prior to the bankruptcy even though it was not a partner in the partnership for any of these years. This is because a person who is eligible to be TMP includes a general partner in the partnership as of the time the designation is made. See Temp. Treas. Reg. § 301.6231(a)(7)-1T(b)(ii). Moreover, if no

designation of TMP is made by the partnership in accordance with the temporary regulations, then [redacted] should be selected by the Service as the partnership's TMP in accordance with section 6231(a)(7). We note that [redacted] is not eligible to be selected TMP by the Service for any years prior to which it was a partner on the basis that it has the largest profits interest in the partnership since section 6231(a)(7)(B) requires the TMP to be, "the general partner having the largest profits interest in the partnership at the close of the taxable year involved." Rather, because of the bankruptcies of [redacted] and [redacted], [redacted] should be selected TMP based on the fact that it is impracticable to apply the largest profits interest general partner rule of section 6231(a)(7)(B). See Rev. Proc. 88-16, 1988-1 C.B., section 3.03.

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Should you have any further questions regarding this matter, please contact Jeffrey I. Rosenberg at (FTS) 566-3233.

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